

## NOTE 8 – DEPOSITS AND INVESTMENTS

This note provides information for all deposits and investments except those of the Common Cash pool, which are described in Note 5.

### ***Deposits - Primary Government***

#### **Custodial Credit Risk**

In addition to equity in the Common Cash pool, some State funds maintain deposits with financial institutions. At present, only the Michigan Unemployment Compensation Funds (MUCF), the State Treasurer's Escrow and Paying Agent Fund, the Attorney Discipline System, and the Michigan Educational Savings Plan maintain these deposits and are exposed to custodial credit risk.

The Michigan Employment Security Commission (MESC) administers, under the auspices of the federal government, the deposits of the MUCF. Tax collections are deposited in a clearing account as required by the Michigan Employment Security Act. Refunds are paid from that account; after the clearance of vouchers for refunds, all other money remaining in the fund, less amounts needed for refunds and judgments, must be deposited with the Secretary of the Treasury of the United States of America to the credit of the State in the Unemployment Trust Fund, established and maintained pursuant to Section 904 of the Social Security Act, 42 USC 1104. These deposits are maintained in the Federal Reserve Bank. At year-end, the carrying amount of these deposits, excluding those classified as investments, was negative \$10.8 million, which was caused by a net book cash overdraft. The bank balance of the deposits was \$11.0 million, of which \$1.1 million was covered by federal depository insurance and \$10.9 million was book-entry securities held by pledging custodial banks at the Federal Reserve Bank in the State's name.

The deposits of the State Treasurer's Escrow and Paying Agent Fund were reflected in bank accounts at \$.1 million; these deposits were uninsured and uncollateralized, and were therefore exposed to custodial credit risk. This fund was administratively created and is used to account for investments held in escrow by the State Treasurer as fiscal agent for hospitals that have defeased Michigan State Hospital Finance Authority (MSHFA) bonds. Michigan Compiled Law (MCL) 331.73g allows that the deposits shall be held in trust by the State Treasurer or by a financial institution qualified to serve as trustee pursuant to a trust agreement entered into between the authority issuing the refunding bonds and the State Treasurer or the financial institution providing for the investment and disposition of the funds.

The bank deposits of the Attorney Discipline System were \$37.0 thousand; these deposits were not covered by Federal Deposit Insurance Corporation (FDIC) insurance, but risk was minimal as none of these deposits were uninsured or uncollateralized. The System has no policy to address custodial credit risk. It assesses financial institutions' risk levels; only those with acceptable levels of risk are used as depositories.

The deposits of the Michigan Educational Savings Program were reflected in bank accounts at \$.7 million; \$.1 million was insured and \$.6 million was uninsured and uncollateralized. The level of risk for each financial institution is evaluated and assessed; only those with an acceptable estimated risk level are used as depositories. The program has no other policy for controlling this risk.

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**Investments - Primary Government**

The following table shows the carrying amounts and fair values of investments of the primary government by investment type and in total (in millions) at September 30, 2007:

Primary Government Total Investments				
Investment Types	Pension Funds	Deferred Compensation Defined Benefit Funds	Other Funds	Total
Commercial paper	\$ 3,359.2	\$ -	\$ 33.3	\$ 3,392.5
Money market accounts	-	218.6	309.2	527.8
Government securities	4,740.8	-	888.0	5,628.8
Corporate bonds and notes	5,229.5	-	648.0	5,877.5
Mutual funds	120.7	2,603.9	1,051.2	3,775.7
Pooled investment funds	-	2,101.0	-	2,101.0
Equities	29,159.7	-	.2	29,159.8
Guaranteed investment contracts	-	-	43.8	43.8
Funding agreements	-	-	169.7	169.7
International	6,047.8	-	-	6,047.8
Real estate	5,374.6	-	-	5,374.6
Alternative	8,432.5	-	-	8,432.5
Accrued income	131.5	-	-	131.5
Cash collateral	45.1	-	-	45.1
Unsettled investments	75.6	-	-	75.6
Total	\$ 62,717.0	\$ 4,923.6	\$ 3,143.3	\$ 70,783.9

As reported on the Statement of Net Assets

Current investments	\$ 471.2
Noncurrent investments	804.7
Total Investments	\$ 1,275.9

As reported on the Statements of Net Assets and Statement of Fiduciary Net Assets

	Current Investments	Noncurrent Investments	Total
Governmental Activities	\$ 288.9	\$ 509.2	\$ 798.1
Business-type activities	182.3	295.5	477.8
Fiduciary funds	1,290.7	68,217.3	69,508.0
Total Investments	\$ 1,761.9	\$ 69,022.0	\$ 70,783.9

**Authority**

Investment authority for the State's pension (and other employee benefit) trust funds is found in MCL Section 38.1133. This law allows the State Treasurer, as investment fiduciary, to make diverse investments in stocks, corporate and government bonds and notes, mortgages, real estate, venture capital, and other investments. The law has prudence standards and requires that the assets of a retirement system shall be invested solely in the interest of the participants and beneficiaries, and be made for the exclusive purpose of providing benefits to the participants and the participants' beneficiaries, and of defraying reasonable expenses of investing the assets of the State system.

The investment authority for other State funds is found in their enabling statutes and/or their bond resolutions where applicable. Except as noted below, the investments of the non-pension (and other employee benefit) trust funds are comprised mostly of United States government securities.

The State Building Authority makes diverse investments as allowed by State statute and/or bond resolutions.

The Michigan Tobacco Settlement Finance Authority (MTSFA) is authorized to invest at its discretion, in any obligation, as it determines to be proper, in accordance with MCL Section 129.267.

Investments of MUCF represent their interest in a U.S. Treasury trust fund managed by the Secretary of the Treasury pursuant to Title IX of the Social Security Act, which includes deposits from the unemployment compensation funds of various states. MUCF is credited quarterly with trust fund investment earnings, as computed on a daily basis.

The deferred compensation plans are invested in mutual funds, U.S. Treasury strips, money market funds, and pooled investment funds. During fiscal year 2007, the deferred compensation plans' investment activities were managed by a private investment firm, which invests as directed by members of the plan.

#### **Derivatives**

The State Treasurer is also authorized to invest a limited amount of pension (and other employee benefit) trust funds in derivatives to provide additional diversification. Such investments were made in swap agreements, Standard & Poor's 500 and Standard & Poor's Midcap Index and Bond Index futures contracts, and option contracts during the year. At September 30, 2007, there was \$4.2 billion invested in swap agreements, futures contracts, and option contracts. Derivatives are not used for speculation and they are not used to leverage the investment portfolios. Approximately 12% of the total pension (and other employee benefit) trust funds portfolio has been invested from time to time in swap agreements, futures contracts, and option contracts. The swap agreements pay quarterly to the counterparty, over the term of the swap agreements, interest indexed to the three month London Interbank Offered Rate (LIBOR), adjusted for an interest rate spread, on the notional amount stated in the agreements. United States domestic LIBOR-based floating rate notes and short-term investments were purchased in the open market to correspond with the notional amount of the swap agreements. The State Treasurer maintains custody and control of these floating rate notes and short-term investments. Swap agreements represent the largest category of derivatives used and total approximately 6.6% of the total portfolio.

#### **Investment Pools**

In July 2004, four state retirement systems' (State Employees', State Police, Public School Employees', and Judges') investments were contributed to an investment pool structure. A pro rata share of the entire pool represents each system's ownership of a portion of the investments in the State's pool.

#### **Repurchase Agreements**

As a matter of administrative policy, the State Treasurer makes only limited use of investments in repurchase agreements. No such investments were outstanding at year-end.

#### **Risk**

GASB Statement No. 40 requires certain disclosures regarding policies and practices with respect to the risks associated with investments. The custodial credit risk, the credit risk, the interest rate risk, the foreign currency risk and concentration of credit risk are discussed in the following paragraphs.

#### **Custodial Credit Risk**

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty to a transaction, the State will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government and are held by either the counterparty, or the counterparty's trust department or agent, but not in the government's name.

The State Treasurer does not have a policy for limiting custodial credit risk. As of September 30, 2007, government securities with a market value of \$24.8 million were exposed to custodial credit risk. These securities were held by the counterparty, not in the name of the retirement systems.

#### **Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Short-term investment for the pension funds are in prime commercial paper and follow the same policy described in Note 5 for this type of investment. The ratings at September 30 are included in the rated debt investment table.

All long-term fixed income investments, unless unrated, must be investment-grade at the time of purchase, unless specific requirements are met. Investment grade, as defined in MCL Section 38.1132 includes: investments in the top four major grades, rated by two national rating services. The State Treasurer's policy is to use Standard & Poor's (AAA, AA, A, BBB); and Moody's (Aaa, Aa, A, Baa). The primary government's rated debt investments as of September 30, 2007, are presented below. Note that securities backed by the full faith and credit of the United States Government are excluded.

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Debt Investments (In millions)				
Investment Type	Fair Value	Rating S & P	Fair Value	Rating Moody's
<b>Pension (and Other Employee Benefit) Trust Funds:</b>				
<b>Retirement Systems:</b>				
<b>Commercial paper</b>	\$ 3,040.7	A-1	\$ 3,185.2	P-1
	324.4	Unrated	179.9	Unrated
<b>Government securities</b>				
U.S. agencies – sponsored	3,519.9	AAA	3,519.9	Aaa
<b>Corporate bonds &amp; notes</b>	814.0	AAA	752.7	Aaa
	936.8	AA	1,029.1	Aa
	1,662.0	A	1,606.0	A
	639.2	BBB	689.8	Baa
	17.6	BB	17.0	Ba
	4.2	B	-	B
	-	CCC	1.8	Caa
	178.7	Unrated	156.2	Unrated
<b>International*</b>	330.1	AAA	330.1	Aaa
	948.1	AA	1,568.4	Aa
	455.5	A	100.2	A
	365.0	Unrated	100.0	Unrated
<b>Mutual funds**</b>	48.8	AA	48.8	Aa
Total	13,285.1		13,285.1	
<b>Deferred Compensation/Defined Contribution:</b>				
<b>Common trust funds</b>	\$ 7.4	AAA	\$ 7.4	Unavailable
	1,352.2	AA	1,352.2	Unavailable
	16.1	Unrated	16.1	Unrated
<b>Mutual funds</b>	59.2	AA	59.2	Unavailable
<b>Money market funds</b>	218.6	A-1+	218.6	Unavailable
Total	1,653.5		1,653.5	
<b>Other Primary Government Funds:</b>				
<b>Commercial paper</b>	\$ 33.3	A-1+	\$ 33.3	Unavailable
<b>Government securities</b>				
U.S. agencies - sponsored	326.6	AAA	288.5	Aaa
U.S. agencies - sponsored	34.6	A-1+	72.7	Unavailable
<b>Corporate bonds &amp; notes</b>	77.3	AAA	68.1	Aaa
	5.9	AA	5.4	Aa
	43.7	A	53.3	A
	3.9	BBB	3.9	Baa
<b>Guaranteed investment contract</b>	37.8	A	37.8	Unavailable
	6.0	NR	6.0	NR
<b>Mutual funds</b>	127.9	Unavailable	127.9	Aaa
	389.3	Unavailable	389.3	Aa1/Aa2
<b>Treasury trust fund pool</b>	103.6	Unrated	103.6	Unrated
Total	1,190.0		1,190.0	
<b>Total Primary Government</b>	<u>\$ 16,128.7</u>		<u>\$ 16,128.7</u>	

\*International and Equity Investment types consist of domestic floating rate notes that are used as part of a Swap strategy.

\*\*Average Quality Rating.

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**Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates of debt investments that will adversely affect the fair value of those investments.

The State Treasurer's policy states that cash equivalents are invested in short term fixed income securities with an average weighted maturity of less than one year to provide liquidity and safety of principal from capital market and default risk. At September 30, 2007, the fair value of prime commercial paper was \$3.4 billion; the weighted average maturity was 12 days.

The State Treasurer does not have a policy regarding interest rate risk for long-term debt investments. However, the pension trust funds are invested with a long-term strategy with no investments with a maturity of less than one year at the time of purchase. The goal is to balance higher returns while accepting minimum risk for the return. Analyzing the yield curve on individual securities as compared to U.S. Treasuries determines, in part, what is an acceptable risk for the return. Therefore, market conditions such as lower interest rates result in shorter duration; higher interest rates result in longer duration.

As of September 30, 2007, the pension trust funds had the following long-term debt securities:

Pension (and Other Employee Benefit) Trust Funds Debt Securities (In millions)		
	Fair Value	Duration In Years
<b>Retirement Systems:</b>		
<b>Governmental</b>		
U.S. Treasury	\$ 542.7	4.8
U.S. Agency – Backed	1,624.1	5.7
U.S. Agency – Sponsored	3,519.9	3.3
Total Government	<u>5,686.7</u>	
<b>Corporate</b>	4,252.6	4.9
<b>International*</b>		
U.S. Treasury	99.5	.1
Corporate	2,098.7	.1
Total International	<u>2,198.2</u>	
<b>Mutual fund - fixed income</b>	48.8	5.3
Total	<u>\$12,186.4</u>	
<b>Deferred Compensation/Defined Benefit:</b>		
<b>Common trust funds</b>		
Traditional GIC/BICs	\$ 145.5	1.4
Buy and hold synthetics	17.4	1.2
Global wrap synthetic contracts	1,106.4	3.1
SSgA daily bond market index fund	100.3	4.6
Total Common Trust	<u>1,369.6</u>	
<b>Money market funds</b>	218.6	.1
<b>Mutual funds</b>	59.2	8.2
Total	<u>1,647.4</u>	
Total Pension (and Other Employee Benefit) Trust Funds	<u>\$13,833.8</u>	

\*International debt securities contain domestic government and corporate securities as a part of their derivative strategies. The interest rates reset on a quarterly basis for these securities.

For the other primary government funds, fixed income is invested in a laddered, time-segmented structure allowing for intermittent cash flows as needed.

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As of September 30, 2007, the primary government, excluding pension trust funds, had the following debt securities:

Other Funds Debt Securities (In millions)					
Investment Type	Fair Value	Investment Maturities (In years)			
		Less Than 1	1 To 5	6 To 10	More Than 10
U.S. Treasury SLGS	\$ 20.3	\$ 13.4	\$ 6.9	\$ -	\$ -
U.S. Treasury bonds	370.9	75.4	199.4	74.1	22.0
U.S. Bonds – backed	31.9	-	.1	.8	30.9
U.S. Agency bonds – sponsored	361.3	40.6	146.9	146.2	27.5
Corporate bonds	130.7	-	35.9	56.9	37.9
Guaranteed investment contracts	43.8	6.0	-	-	37.8
Mutual funds	517.3	-	-	517.3	-
Total	<u>\$ 1,476.1</u>	<u>\$ 135.4</u>	<u>\$ 389.2</u>	<u>\$ 795.3</u>	<u>\$ 156.2</u>

**Foreign Currency Risk**

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of investments or deposits. The pension trust funds invest in various foreign securities. These investments are limited to 20% of the total assets of the system, and are additionally limited to 5% of the outstanding foreign securities of any single issuer. No investment is allowed in a country that has been identified by the United States State Department as engaging in or sponsoring terrorism. These limits are set forth in MCL Sections 38.1133 and 38.1140. The types of foreign securities include equities, mutual funds, real estate, and limited partnerships. At September 30, 2007, foreign investments were approximately 8% of total assets of the systems; total foreign investments were \$5.1 billion. As of September 30, 2007, the pension (and other employee benefits) trust funds held the following investments subject to foreign currency risk:

Pension (and Other Employee Benefit) Trust Funds					
Foreign Currency Risk (In millions)					
		Market Value (In U.S. Dollars)			
Currency	Country	Alternative Investments**	Equities	Equities - International	
				Equities	Derivatives*
Retirement Systems:					
Americas					
Dollar	Canada	\$ -	\$ -	\$ 59.9	\$ -
Peso	Mexico	-	102.6	-	-
Real	Brazil	-	.6	-	-
Europe					
Euro	European Union	798.9	59.2	236.7	206.8
Franc	Switzerland	-	69.5	43.6	38.4
Krona	Sweden	-	-	19.4	11.9
Krone	Denmark	-	.9	13.0	3.4
Krone	Norway	-	-	15.5	2.2
Sterling	United Kingdom	32.5	5.6	116.2	86.0
Asia/Pacific					
Dollar	Australia	-	-	57.6	35.5
Renminbi	China	-	12.4	-	-
Dollar	Hong Kong	-	-	20.9	33.4
Rupee	India	-	.6	-	-
Yen	Japan	5.5	173.5	139.4	52.7
Dollar	Singapore	-	-	7.4	5.8
Won	South Korea	-	-	21.8	29.5
Middle East					
Shekel	Israel	-	.4	-	-
Mutual Funds					
Various	Various	513.2	44.3	2,070.6	-
Total		\$ 1,350.0	\$ 469.7	\$ 2,822.1	\$ 505.6
Deferred Compensation/Defined Contribution:					
Mutual Funds					
Various	Various	\$ -	\$ 693.3	\$ -	\$ -
Total		\$ 1,350.0	\$ 1,163.0	\$ 2,822.1	\$ 505.6

\*International derivatives' market value exposure to foreign currency risk is the net amount of unrealized gains and unrealized losses. Maturity dates on these investments range from October 2007 through September 2010, with an average maturity of 1.2 years. For more information, see the derivatives section of this note.

\*\*\$513.2 million of investments disclosed in this column consist of international real estate investments held by the pension trust funds.

### **Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributable to the magnitude of a government's investments with a single issuer.

Other than obligations issued that are assumed or guaranteed by the United States, its agencies, or United States government-sponsored enterprises, the pension systems are prohibited by MCL 38.1137 from investing in more than 5% of the outstanding obligations of any one issuer or investing more than 5% of a system's assets in the obligations of any one issuer.

At September 30, 2007, there were no investments in any single issuer more than 5% of the system's assets, nor were there any investments totaling more than 5% of the obligations of any one issuer, other than U.S. Government Securities as described above.

Pension trust fund investments represent 95.6% of the total investments of the primary government. Other large holders of investments were the State Lottery Fund and MUCF.

The State Lottery Fund investments, \$370.9 million, are all in the form of zero coupon U.S. Treasury bonds. These investments are held to provide funding for deferred prize awards.

### **Securities Lending Transactions**

Under the authority of MCL 38.1133, the State lends securities to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The custodian is not liable for any losses unless there is negligence or willful misconduct on its part. State statutes allow the State to participate in securities lending transactions, via a Securities Lending Authorization Agreement, authorizing the agent bank to lend its securities to broker-dealers and banks, pursuant to a form of loan agreement. During the fiscal year, the agent bank, at the direction of the State Treasurer, lent securities and received: cash (United States and foreign currency), securities issued or guaranteed by the United States government, sovereign debt rated A or better, convertible bonds, Canadian provincial debt, and irrevocable bank letters of credit as collateral. The agent bank did not have the ability to pledge or sell collateral securities delivered absent a borrower default. Borrowers were required to deliver collateral for each loan equal to: 1) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; or 2) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

The State Treasurer did not impose any restrictions during the fiscal year on the amount of the loans that the agent bank made on its behalf. The agent bank indemnified the State by agreeing to purchase replacement securities, or return cash collateral in the event the borrower failed to return the loaned securities or pay distributions thereon. There were no such failures by any borrowers to return loaned securities or pay distributions thereon during the fiscal year. Moreover, there were no losses during the fiscal year resulting from a default of the borrowers or the agent bank.

During the fiscal year, the State Treasurer and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in a collective investment pool along with the cash collateral of other qualified and non-qualified tax-exempt plan lenders. As of September 30, 2007, the investment pool had an average duration of 25 days and an average expected maturity of 710 days. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. At September 30, 2007, the retirement systems had no credit risk exposure to borrowers. The collateral held and the market value of securities on loan for the State as of September 30, 2007, were \$13.9 billion and \$13.5 billion, respectively.

## **Deposits and Investments - Discretely Presented Component Units**

### **Deposits**

At year-end, the carrying amount of discretely presented component units deposits, excluding those classified as investments, was \$323.6 million. The deposits were reflected in the accounts of the banks at \$322.2 million. Of the bank balance, \$274.7 million was uninsured and uncollateralized and therefore exposed to custodial credit risk.

### **Investments**

The investment authority for most discretely presented component units is typically found in their enabling statutes and/or their bond resolutions where applicable. Those component units that are financing authorities generally may invest in government or government-backed securities and deposits. The Michigan Education Trust's investments are subject to an investment agreement with the State Treasurer that allows the Treasurer, acting as agent, to make diverse investments including stocks,

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bonds, notes, and other investments. Investment policies for the State universities are typically set forth by their governing boards and include a broad range of investment types.

**Restricted Assets**

Restricted investments on the government-wide Statement of Net Assets, totaling \$423.9 million, represent amounts that are pledged toward the payment of outstanding bonds and notes.

The following table summarizes the investment maturities reported by the discretely presented component units (in millions):

	Investment Maturities (In Years)					N/A
	Fair Market Value	Less Than 1	1 To 5	6 To 10	More Than 10	
<b>Deposits:</b>						
Time deposits	\$ 33.6	\$ 33.1	\$ .5	\$ -	\$ -	\$ -
Government money market accounts	474.9	474.9	-	-	-	-
<b>Investments:</b>						
Commercial paper	251.5	251.5	-	-	-	-
Short-term notes	106.8	102.8	2.5	1.5	-	-
Repurchase agreements	9.8	9.3	-	-	.5	-
Government securities	1,505.7	903.2	314.4	177.0	111.1	-
Insured mortgage backed securities	269.0	2.9	14.6	1.6	249.9	-
Government-backed securities	203.9	-	.4	18.3	185.2	-
Investment agreements	13.9	5.5	-	-	8.4	-
Corporate bonds and notes	186.7	23.7	114.6	26.5	21.9	-
Preferred stock	.9	-	-	-	.9	-
Equities	76.2	36.8	.9	-	3.1	35.4
Real estate	8.0	.7	-	-	5.9	1.4
Venture capital & leveraged buyouts	18.8	-	-	15.8	2.9	-
Government money market funds	11.1	11.1	-	-	-	-
Mutual bond funds	296.2	161.4	81.6	48.4	.2	4.6
Mutual equity funds	878.6	56.9	.8	-	328.2	492.7
Guaranteed investment contracts	839.8	-	45.2	59.1	735.5	-
Pooled investment funds	33.0	33.0	-	-	-	-
Other investments	50.2	2.7	.1	-	46.9	.5
<b>Total Investments</b>	<b>\$ 5,268.6</b>	<b>\$ 2,109.6</b>	<b>\$ 575.6</b>	<b>\$ 348.1</b>	<b>\$ 1,700.6</b>	<b>\$ 534.6</b>
Less Investments Reported as "Cash" on Statement of Net Assets	508.7					
<b>Total Investments</b>	<b>\$ 4,759.9</b>					
<b>As Reported on Statement of Net Assets</b>						
Current investments	\$ 1,378.5					
Noncurrent restricted investments	423.9					
Noncurrent investments	2,957.5					
<b>Total Investments</b>	<b>\$ 4,759.9</b>					